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Pension reform: What Ukraine can learn from Slovakia

Pension reform in Slovakia involved appealing to workers to contribute more to the pension system by tying the size of the eventual pension benefit to the level of contributions. The pay-as-you-go pension system, which guarantees a minimum living standard, was combined with a mandatory contribution system that invests employee deductions in the stock market through private pension funds. The biggest obstacle to this kind of reform, however, is the admittedly large costs to the state during the transition period. These generally have to be covered from other sources and this can put a brake on reforms

Slovakia began to implement pension reform in 2004. The main drive behind this reform was widespread dissatisfaction with the standard of living of pensioners. The state Pension Fund had been in deficit since 1997, causing a steady decline in real pensions. By 2003, the average old-age pension was around 45% of the average wage in the economy, compared to 54% in 1991. The difference between the lowest and the highest pensions was minimal. The system was good only for low-income workers and those who worked in the shadow economy and paid minimal contributions. This trend was further stimulated by globalization processes that enabled high earners to avoid contributing to the system altogether. Soaring unemployment in the late 1990's, together with an expected population crisis, emphasized the need for reform.

Three kinds of pension systems

There are three ways of providing old-age security in the world: through taxes, through saving money (funded schemes), or through insurance (nonfunded, often in the form of PAYG schemes). In the funded scheme, workers set aside a part of their salaries and accumulate these savings in order to use them after retirement. Both other forms, taxes and insurance schemes, are based on an intergenerational exchange in which current workers pay out current pensioners.

Accepting World Bank recommendations and learning from similar reforms in Hungary and Poland, the new Slovak government decided to build a pension system based on three tiers and a safety net for people with overly low pensions. The old PAYG (pay-as-you-go) system was split into mandatory social insurance (1st tier) and mandatory savings (2nd tier), complemented by a smaller system of voluntary savings (3rd tier). The PAYG system was clearly separated and reduced to simply guaranteeing a subsistence minimum financed by taxes.

What reforms to the PAYG system brought

The reform of the 1st tier of the pension system brought four major innovations:

- **Gradual extensions of statutory retirement age** from an average 55 years for women and 60 years for men to 62 years for both.
- **A new pension formula**. Higher pension are given to those who earned more and paid higher contributions during their working years. This new formula should increase incentives to pay contributions and eliminate evasion. Since such a system contains a certain risk for people with lower pensions, the assumption is that they will be supported directly from the State Budget.
- **New indexation of awarded pensions.** The "Swiss method" provides for an automatic yearly indexing of pensions based on the weighted average of the CPI (inflation) and average nominal wage growth throughout the economy. The coefficients are 0.5 for both parameters. In general, changes in indexation lessen political influence on the calculation of pensions and bind them to the development of economic indicators instead.
- **Early and late retirement.** The reformed PAYG system allows for both early and late retirement. Each month of earlier retirement reduces a pension by 0.5% and each month of later retirement raises it by 0.5%.

Predictable drawbacks to reform

Although the new PAYG strengthens incentives, it does not respond automatically to change in employment. These have crucial impact on collected contributions and represent key limiting factors for the amount of a pension. Yet neither the pension calculation formula nor the indexation rules reflect such changes and the system continues to make promises it cannot guarantee. Based on population trends, problems could surface as soon as 2015. This would then require another reform of the PAYG system involving several options. Among them are further extending retirement age, increasing contributions, changing the pension formula and/or changing indexation (for example, to include only inflation, which is expected to be lower than wage growth).

The second tier: Mandatory contributions

The new mandatory 2nd tier kicked in on 1 January 2005. All citizens under 52 years of age are allowed to choose to enter the funded tier until June 2006, while young people first entering the labor market are obliged to go into this tier. Their assets will be managed by private pension funds competing on the market and supervised by an independent Fiscal Supervision

Table 1. Private pension funds

	Portfolio		Risk & Return
	equities	bonds	
Growth fund	up to 80%	no limit	high
Balanced fund	up to 50%	at least 50%	medium
Conservative fund	0%	100%	low

Source: INEKO, based on the Slovak Law on Old-Age Pension Savings

Authority. Each pension company will manage three funds with different investment limits and different risk & return relationships (see **Table 1**). Money paid to the 2nd tier will be the private, hereditary ownership of depositors. The interest earned on these funds will not be taxed.

Equity is too volatile to provide a stable income in retirement years, although it can be a valuable component of an investment portfolio during the accumulation phase. Bonds provide more stable income, at the cost of lower returns. For this reason, clients of pension funds invest initially in equity, to gain the advantage of a large, though volatile return, and then shift gradually to bonds as the date of retirement approaches. In order to allow for this kind of investment strategy, Slovak reformers require three different funds. Each depositor is allowed to hold assets only in one fund at a time. At 15 years before retirement, the individual can no longer hold assets in the growth fund and 7 years before retirement they have to completely shift assets to the conservative fund.

The state directly guarantees neither the specific performance of pension funds, nor the principal value of paid contributions. Indirectly, the law imposes strict investment limits on private pension funds and regulates them strictly while requiring some minimum performance relative to their competitors. Moreover, the state guarantees 100% of the granted pension in case of fraud or malfeasance.

The second tier: highly popular

The number of people switching into the 2nd tier exceeded expectations in both Hungary and Poland. The reason was widespread distrust in the state pension system and the willingness of workers to save into a personal account. This factor makes the introduction of the 2nd tier easier. Since having a large number of people switching raises transition costs, it may be necessary to consider regulating the switching process.

The high cost of transition can inhibit reforms

The introduction of the 2nd tier means high transition costs for the first few decades. These are a consequence of diverting contributions from the PAYG system into this tier: the state receives less money but still has to pay out the same pensions. Transition costs depend positively on the contribution rate in the funded tier and on the number of people switching. In Slovakia, these costs are expected to be around 1% of GDP yearly.

The costs of the transition period can be covered by:

- Budget;
- borrowings;
- raising the retirement age; or
- privatization revenues.

PAYG reserves and privatization revenues are expected to cover all Slovak transition costs until 2011. However, a lack of funding can appear earlier where there is massive switching that tends to be accompanied by higher outlays during the transition period. In the long run, even after extending retirement age to 65 years for both genders, there will likely be a gap in the PAYG financial balance after 2030. However, after 2054, the PAYG system will turn into a surplus, with the majority of pensioners taking a combined pension from the funded and PAYG tiers. ■

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For the entire text, visit the ICPS site at: http://www.icps.com.ua/doc/FINALBRIEFPensions.doc

Attention journalists!

In order to improve the quality of economic policy debate in Ukraine, a joint project of ICPS has prepared five analytical briefs:

- Business Environment Reforms in Central Europe;
- Pension Reform in Slovakia;
- Social Security and Poverty Reduction Reforms in Slovakia and in the Rest of the Central Europe;
- Health Care Reforms in Central and Eastern Europe;
- Tax Reforms in the Visegrad Countries and Their Relevance to the Ukraine Situation.

They include recommendations for Ukraine. All five can be downloaded at *http://www.icps.kiev.ua/eng/project.html?pid=67*.

Prepared under the auspices of a joint project between ICPS and the Institute of Economic and Social Reform (INEKO) in Bratislava, the authors are leading researchers and politicians from Poland, Slovakia, Hungary and the Czech Republic. They are prepared to comment to the press on the experience of economic reform in their countries, to provide advice on reforms in Ukraine, and to respond to general questions about the economies of Slovakia and other Central European countries who joined the EU last year. If you have any questions on this, you can contact Yevhen Shulha at yshulha@icps.kiev.ua or directly e-mail any of the authors:

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